Four Steps to Reduce Your Debt

Overview

Simple steps you can take to reduce your debt.

- Admit that you have a problem and commit yourself to fixing it.
- Stop debt spending.
- Make a spending plan.
- Pay down your debts month by month. Pay them off one by one.
- Monthly spending chart

Getting out of debt isn't easy. It takes time, commitment, and sacrifice. But it's not complicated either. It takes just four steps.

1. Admit that you have a problem and commit yourself to fixing it.
Only you can solve your debt problem. And you can only solve it if you decide that it's a problem worth solving.

There are a few ways of making that commitment. Some experts recommend writing a statement owning up to the problem and signing it. Others suggest that you call a family meeting and have an open discussion of the debts you face. A debt problem is rarely felt or solved by just one person, and the ideas and efforts of every member of the family may be needed to get you back in the black. People often find that this open acknowledgment of a debt problem is a relief to the others in their family. And it usually comes as no surprise.

The other effective way to make a commitment to solving a debt problem is to talk with a financial counselor or attend a meeting of others with debt problems. Talking about a problem pushes you to admit to yourself that you really do need to take action. Knowing that you'll be expected to talk again to that same person or group and report on your progress is also a powerful incentive to act and to stay on track once you start. Also, finding other people who understand your problem and who have come up with ways to deal with similar problems can be a huge relief if you've been shouldering this worry yourself for a long time.

2. Stop debt spending.
Take your credit cards, store cards, and gas cards out of your wallet or pocketbook and put them in a drawer at home. Starting right now, get through an entire day without borrowing money or charging anything. Pay cash, write checks, or use a debit or ATM card.

You'll find that this in itself cuts your spending and pushes you to make only planned purchases. It will also show you what life feels like without debt spending. Most people are surprised at how easy it is to make the switch. Even travel and car rentals can be managed with cash and checks. A bank or debit (or ATM) card is an easy alternative. It can be used just like a credit card, but without the debt effect. The money comes right out of your bank account every time you use it.

Once you get through today, you can decide about the next day. And if you manage that, take on another day.

After a week or so of no debt spending, you'll be ready to make an even bigger commitment. Keeping credit cards in a drawer at home is like closing a gate on a problem and not locking it. If you have a real debt problem, you need to lock the gate. Cut up your credit cards. And cancel the credit reserve or overdraft feature on your checking account. This will feel like a drastic step, but it's the access to credit that's the biggest danger to you until you get your debt down to a healthy level. Later on, once your finances are back under control, you can decide to ask for a new copy of one of your cards.

3. Make a spending plan.

A "no debt spending" policy will push you to pay more attention to your spending. The next step is to get a clear picture of that spending and develop a new spending plan.

You might think you already know how you spend your money. But without tracking your spending, you'll find you don't really know where all of your money is going. We simply have too many expenses to keep track of in our heads. And it's the daily cash spending and the extra expenses -- like car repairs, meals out, or holiday gifts -- that push us into debt spending.

Track your cash spending.

Cut some pieces of plain paper down to the size of dollar bills, and put them in your wallet with your cash. Mark the first slip with today's date and the date of the week. For the rest of the day, use it to write down every bit of cash you spend and what you spend it on. (Use it just like you would use the register in your checkbook to make a note of the checks you write.) Keep it simple so this doesn't become a burden. All you really need to write down is the amount spent and what you spent it on. Like this:

- Coffee $1.50
- Lunch $5.00
- Gas $32.63
- Magazines $4.50
- Lottery tickets $3.00
- Snack from vending machine $1.50

Try it for a day. You'll be amazed at how easy it is and how much it shows you. You won't wonder any more what happened to that $50 or $100 you put in your wallet. You'll just know.

Once you see how easy it is, keep going. Track your cash spending every day for a week.

Track the checks you write and payments you make with your debit or ATM cards.

Paying by check or debit card is the other main way people part with their money. If you're in the habit of recording every check you write and every payment you make with your debit card, that's good. If you're not in that habit, now is the time to start. Every time you write a check, write down the number of the check (so you can be sure you haven't missed any), the date, to whom you wrote the check, what it was for, and the exact amount of the check (to the penny). Every time you pay with your debit or ATM card, write the amount in your checkbook register just as you would with a check.

With this information in your checkbook register and the notes you're making on your cash spending, you'll be able to build a complete picture of your spending over time.

What about spending by credit card or charge card? Should you be tracking that, too? No, for two reasons. The first, and most important, is that you aren't using those cards right now. For today, you're not adding to your debt. The second is an accounting reason. You'll make payments on those cards to pay down the balance, and those payments will come from your checking account. What you're tracking here is the money as it leaves your checking account and the cash as it leaves your wallet.

Combine your notes into a weekly and monthly spending record.

Once you have a few days of information on your spending activity, the next step is to start combining your numbers into a weekly and monthly spending record. A monthly record is the most useful measure, since so many expenses fall into a monthly cycle. A simple way to track spending by week so that you can total it up by month is to divide your weeks according to the days of the month.

- Week 1 starts on the 1st of the month and ends on the 7th
- Week 2 starts on the 8th of the month and ends on the 14th
- Week 3 starts on the 15th of the month and ends on the 21st
- Week 4 starts on the 22nd and ends on the last day of the month (so it will usually be a nine- or ten-day "week")

When you track spending this way, your "weeks" will sometimes start and end in the middle of a week, and the fourth week won't be a true week at all. But four "weeks" tracked in this way will make a full month, and will include all of your monthly housing and utility expenses.

You can use the form at the end of this article to track your spending. Feel free to change the categories or add categories to make it easier to group your expenses. Just don't make it too complicated. The idea is to get a clear picture of your expenses, not a microscopic image of every detail.

Make a plan to cut your spending

If you're like most people with debt problems, you're in your current financial state simply because you've spent more than you earn. Now that you see how much you're spending, you can make a plan to cut that spending to a level that will not only keep you from adding to your debt, but let you pay down your debt more quickly.

When most people begin to track their expenses, they find a couple of big surprises that then become the biggest opportunities for trimming their spending. It might be meals out. It might be books or movies. It might be car expenses. Whatever the surprises are for you, start there. The far right column of the chart, labeled "Spending plan," is where you should write down a realistic new goal for that category of spending.

In some cases, when people line up their expenses with their income, the expenses are so much higher than the income that drastic steps need to be taken. They may need to sell an expensive car and replace it with a less expensive model, or perhaps get rid of the car altogether and rely on carpools or public transportation. They may need to move to less expensive housing. If you're in this situation, it may help to talk with a debt counselor to get an expert opinion on what's pushing your budget so far out of balance. A good financial counselor can help you understand whether a drastic change is needed.

Almost always, though, it's the casual spending on meals out, music, movies, electronic equipment, and other "impulse" extras that have to be trimmed to make a healthier spending plan. And extra money can almost always be found through smarter shopping for the things now bought at too-high prices.

The goal of a spending plan is actually very modest: to bring expenses into line with income so that you stop adding to your debt, and to come up with an extra $50 or $100 a month to put toward debt repayment.

For most people, the key to getting out of debt lies in more careful spending. But you may also have some opportunities to increase your income. Just be careful not to let your debts push you into a miserable grind of round-the-clock work. The goal is to get your debt down to a level where it no longer controls your life. You want to be in control of your money and your life.

Look back at your monthly spending chart. Write down your new spending goals for every category of your spending. Some may not change at all and you may be able to cut others dramatically.

Now estimate how much you can save every month if you follow your plan. Add to that any extra money you think you can make. Write the amount down at the bottom of the chart.

This is what you'll be able to pay each month, starting now, toward reducing your debts and building an emergency savings account.

4. Pay down your debts month by month. Pay them off one by one.
The next step is to make a list, using the form on the next page, of all the debt payments you make each month. Include payments on credit cards, store cards, installment loans, home equity loans, payments to repay personal loans to friends and family -- payments on everything you owe to anybody. (Don't include mortgage payments. Like rent, they are a basic housing cost. And unlike your other debts, you can pay off your mortgage at any time by selling your home.)

For each debt, list:

- The name of the creditor (the bank, credit card, business, or person to whom you owe money)
- What you normally pay (or what you'll pay this month if it varies)
- The total amount you owe (the exact amount from your most recent bill or statement)
- The annual interest rate that is applied to the balance (If that interest is set at a special low rate for a limited time, write down the date that it will go up.)

The interest rate may be hard to find. It may be buried within the small type on the back of your bill. If you can't find it listed on your bill or statement, call the creditor and ask what interest rate is being charged on your account.

Many credit cards have different rates for balance transfers, purchases, and cash advances. Your bill should show how much of your balance falls into each of these categories, and what the interest rate is for each. If you have balances in more than one category, estimate or use a calculator to figure out what the average interest rate is for the entire balance on that card.

Credit card or loan	Total balance due	Interest rate	Monthly payment
______________________	________	________	________
______________________	________	________	________
______________________	________	________	________
______________________	________	________	________
______________________	________	________	________
______________________	________	________	________
______________________	________	________	________
______________________	________	________	________
Total balance due	________	**Total monthly payment**	________

Once you write this information on a list, it's easy to see how big or how small your problem is. Knowing the actual number grounds you in reality and lets you get down to the business of chipping away at your debts to make them smaller and more manageable. When it comes to getting out of debt, knowledge really is power.

Now you're ready to come up with a debt repayment plan. If you can find another $50 or $100 each month to pay toward your debts, you can start to wipe them away -- one by one, month by month.

Look back at your monthly spending chart and the amount you decided that your spending plan would save every month. Divide that amount in half. This is how much you can add to your debt payments, starting this month. (Put the other half into a savings account as a cushion against any interruption in your income or unexpected expenses. If you already have $2,500 or more in a savings account, then you can apply the entire amount saved from your spending plan to reducing your debt.)

Monthly savings from my spending plan		**My monthly debt payment allowance**
$ ________________	**÷ 2 =**	**$ ________________**

Now look at your list of debts. Choose one to pay off first. It should either be the one with the highest interest rate or the one with the lowest balance. It's your choice. The one with the higher interest rate is costing you the most every month. You'll make a bigger impact on your spending if you pay that one off first. But the satisfaction of paying a loan off completely is an important motivation, and that will happen sooner if you choose the loan with the smallest balance.

Starting this month, add your extra debt-payment allowance to your payment toward the debt you've singled out. So if you had been paying the minimum of $20 a month on a credit card bill and you've decided you can add $50 to your debt payments, you'll pay $70 a month toward this card. Keep making your regular monthly payments toward the other debts. You'll get to them next.

An extra $50 or $100 payment every month may not seem like much, but it makes a huge difference in how long it takes to repay a debt and to the total amount you pay. An extra $50 per month can reduce the time it takes to pay off a $4,000 credit card balance from 45 years to less than six years. And depending on your interest rate, it can reduce the total amount of interest you pay by thousands of dollars. Paying an extra $100 per month reduces the payoff time to just over three years and the total interest by half.

As you focus your repayment efforts on that one debt, you'll have the satisfaction of seeing the balance shrink over the course of several months until it finally disappears. When that happens, it will be time to move on to the next debt. And here's where the magic of interest rates starts to work in your favor. When you pay off the first debt, you free up the money you were paying in interest on that loan. Now you'll be able to pay even more each month toward the second debt, and the speed of your repayment plan will begin to pick up.

Let's say you were paying $70 a month toward the first loan (the $20 minimum payment plus the $50 you added). And let's suppose the minimum payment on the second loan is $30. You can actually afford to pay $100 a month toward that second loan now (the $70 you were paying toward the first loan, plus the $30 minimum on the second). You just need to keep to your spending plan. You'll be paying the same amount of money toward your debts, and those debts will be disappearing faster.

Stick with it

This four-step plan has worked for thousands of people who have overcome serious debt problems. It's the basis of the support offered through professional debt counseling and through groups such as Debtors Anonymous. But it's important to remember that it's not a quick fix. It takes time and your steady commitment to stick with the plan.

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Monthly spending

Month of ___________________

	Week 1	Week 2	Week 3	Week 4	Total for month	Spending plan
Mortgage or rent						
2nd mortgage / equity loan						
Property tax / association fees						
Home maintenance						
Heat / fuel						
Electricity						
Telephone -- basic						
Telephone -- long distance						
Cellular / pager / Blackberry / Internet						
Water / sewage						
Trash						
Groceries / household goods						
Meals out / lunches						
Child care						
Child support						
Vehicle #1 payment / lease						
Vehicle #2 payment / lease						
Gasoline / tolls / parking						
Car maintenance						
Car insurance						
Public transportation						
Homeowner’s / renter’s insurance						
Life insurance (outside of work)						

	Week 1	Week 2	Week 3	Week 4	Total for month	Spending plan
Medical expenses (out of pocket)						
Dental / vision expenses (out of pocket)						
Drugs / prescriptions						
Laundry / dry cleaning						
Clothing						
Cable / videos / DVDs						
Entertainment / hobbies						
Gaming (lottery, casino, etc.)						
Tobacco						
Alcohol						
Gifts / major / other						
Contributions / donations						
Beauty products and services						
Pet / veterinarian						
License / dues						
Vacation / travel						
Lessons / tuition						
Kids' allowances						
Health club / exercise equipment						
Emergency fund						
Other expenses						
Total expenses						

Monthly savings from my spending plan

$ ________________________